



April 3, 2001

## **Democrat Plan Fails Basic Test**

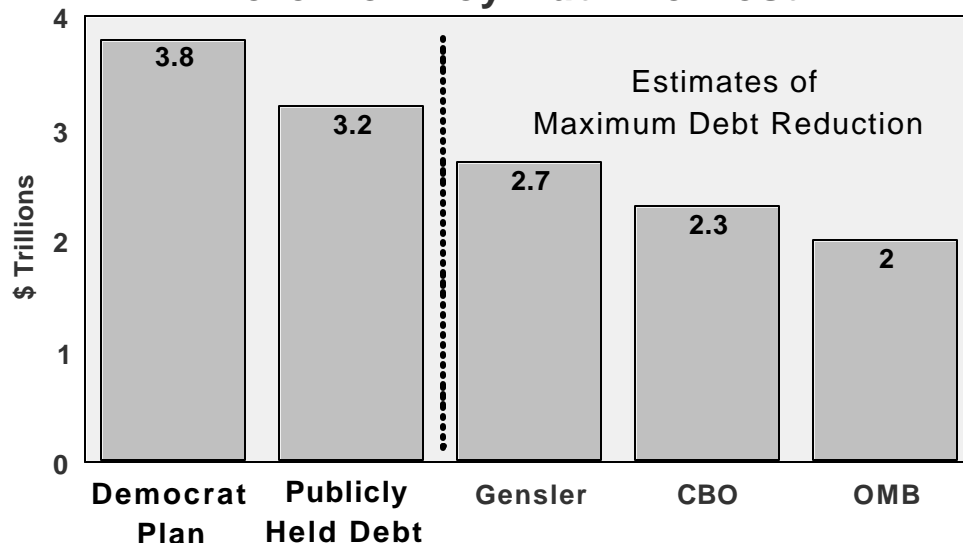
# **Debt Management 101**

Republicans are preparing to adopt a budget resolution that continues to pay down the debt while providing much-needed tax relief for all taxpayers *and* increased spending for critical areas like health, education, and our national defense.

An essential part of the Republican plan is the measured, responsible level of debt reduction over the next 10 years — a reduction of more than \$2 trillion. This debt reduction will reduce federal interest costs by more than 90 percent while giving the Treasury Department the flexibility to continue its primary debt-management goals of 1) ensuring efficient cash management, 2) minimizing costs to the taxpayer, and 3) promoting efficient capital markets.

On the other hand, Democrats have proposed a plan that literally claims to pay down more debt than the federal government owes to the public! If enacted, the Democrat budget outline would create havoc in America's bond markets, cost taxpayers tens of billions in unnecessary debt expenses, and do nothing to protect the remaining surplus from a new, uncontrolled, congressional spending binge.

### **Democrat Proposal "Debt Reduction" Exceeds Debt Where Do They Put The Rest?**



Source: OMB, CBO

## **Democrats Mislead – By Any Measure**

Last month, the Senate Budget Committee held hearings on federal debt management that demonstrated — by any measure — the Democrat plan sets aside significantly more surplus than possibly can be redeemed on debt. For example, the Office of Budget and Management (OMB) estimates that only \$2 trillion of the \$3.2 trillion debt could be reasonably redeemed over the next 10 years. That estimate would leave the Democrat budget outline with \$1.8 trillion in “surplus” surpluses to spend on new government programs.

On the other end of the spectrum, the Democrat witness at the hearing, former Clinton Administration Treasury Under Secretary Gary Gensler, testified:

By discontinuing new issuance of long-maturity debt, using debt buybacks, and possibly reinitiating debt exchanges, Treasury could smoothly retire one-half, and possibly up to two-thirds, of its current long-term marketable debt in private hands over the next 10 years. . . . In sum, the amount of truly unavailable debt should be thought of as less than \$500 billion.

Even at face value, Mr. Gensler’s debt estimate and the Democrat budget outline are incompatible. Mr. Gensler believes \$2.7 trillion in publicly-held debt could be redeemed over the next 10 years — \$3.2 trillion in existing debt minus the \$500 billion he believes cannot be redeemed. But the Democrat budget includes \$3.8 trillion in debt relief. Where does the extra \$1.1 trillion go? Even with Mr. Gensler’s generous estimates, the Democrat budget is still a stealth spending plan.

## **Pioneering Economic Theory – or Just Fuzzy Math?**

Nor should the Senate take Mr. Gensler’s estimate at face value. To get to \$2.7 trillion in redeemable debt, Mr. Gensler ignores potential costs to taxpayers of large Treasury buy-backs. Whereas others have argued that a policy to eliminate federal debt entirely would cost taxpayers a “scarcity” premium of several hundred billion dollars, Gensler argues that as the publicly-held debt shrinks, the Treasuries themselves actually will become less valuable.

This argument is a remarkable new economic theory that could win Mr. Gensler a Nobel Prize if he could back it up. Unfortunately, he can’t. The laws of supply and demand apply to Treasuries just as they apply to all other goods. Under the Democrat policy of buying back all the debt over the next 10 years, taxpayers will incur a huge “scarcity” premium.

Mr. Gensler’s argument revolves around the observation that investors “generally value liquidity and are willing to pay more for large liquid issues.” Therefore, the smaller the federal debt, the less liquidity there is and the less valuable the Treasuries are to investors. Mr. Gensler cites several smaller Treasury issues as evidence that the smaller, less liquid Treasuries sell for less than the larger issues.

But investors value Treasuries for more than just their liquidity. Treasuries offer investors a store of value and a competitive income stream, and they are relatively risk-free. All Treasuries, new and old, liquid and illiquid, offer these values.

Moreover, the Gensler argument relies upon an ongoing, dynamic market: As long as new, more liquid Treasuries are being issued, the old, less liquid Treasuries will be relatively lower valued. But the Democrat budget assumes that at some point during the next 10 years, the Treasury will stop issuing new bonds. Moreover, adoption of the Democrat budget would require the Treasury to redeem all outstanding Treasuries. At that point, the ongoing Treasury market becomes defunct, and Gensler's argument irrelevant.

The new, shrinking market will be a market of scarcity: privately-held federal securities will grow in value as the total pool of available Treasuries shrinks and the cash reserves of the Treasury Department grow. For that reason, adopting a plan that *requires* all publicly-held debt to be redeemed this decade ensures that taxpayers will be forced to pay a significant "scarcity" premium. As Federal Reserve Chairman Greenspan recently observed, convincing investors to part with their Treasuries prior to maturity would be "extraordinarily expensive and obviously undesirable."

The Democrat plan is not only a stealth spending plan, it also imposes new, higher costs on taxpayers.

## **Sleight-Of-Hand Budgeting**

In response to criticism of their stealth spending plan, Democrats have resorted to creating new budget terms. Under the Democrat budget outline, they will set aside the Social Security and Medicare Part A surpluses for debt reduction only. That's \$2.9 trillion in debt relief. Their budget then divides the remaining \$2.7 trillion of the projected surplus into three parts — \$900 billion for tax relief (and new welfare spending), \$900 billion for new government spending, and \$900 billion for "long-term debt."

But what exactly is "long-term" debt? Judging from the remarks of Senator Conrad, it's distinct from the \$3.2 trillion debt held by the public. It could be the unfunded liabilities of Medicare and Social Security, but setting aside surpluses in excess of publicly-held debt does nothing to address these liabilities. Nor can we buy back the bonds held by the Social Security Administration. Under law, the only investment the Social Security Administration can make is Treasury bond purchases.

Social Security and Medicare present taxpayers with a long-term, unfunded liability. That is, expected payroll taxes over the next 75 years are several trillion dollars less than the expected benefits to be paid out.

The President and numerous members of Congress have suggested that Social Security and/or on-budget surpluses should be used to pre-fund these benefits through individually-owned and controlled Personal Savings Accounts. The Democrats could use this \$900-billion slush fund to create

these popular accounts, but Senator Conrad and most other Democrats have voted against such a proposal (see, for example, RVA #56, 4/1/98).

On the other hand, Senator Conrad and the Democrats could use the \$900 billion to buy private industries. The Clinton Administration proposed to go out and buy lots of private securities just last year as part of its budget last year. But Senator Conrad and all the Democrats voted against this proposal just last year.

So most Democrats oppose creating individual accounts, and they all oppose direct government investment. What else can the Democrats do with the \$900 billion?

Nothing.

Absent outstanding publicly-held debt, direct government investment, or the creation of individual accounts as part of comprehensive Social Security reform, *there is nothing* the Treasury Department can do with these extra funds.

## **The Democrat Stealth Spending Plan**

By any measure — Gensler's or the Bush OMB's — the Democrat budget calls for more debt relief than there is debt available to be redeemed. The only rationale for such a policy is to block legitimate tax relief while creating a slush fund that can be used to finance new federal spending. In the process, the Democrat alternative would destroy any semblance of efficient cash management while costing American taxpayers hundreds of billions in unnecessary costs.

Written by Brian Reardon, 224-2946